



**STATE BOARD OF EQUALIZATION
STAFF LEGISLATIVE BILL ANALYSIS**

DRAFT

Date Introduced:	02/15/11	Bill No:	Senate Bill 330
Tax Program:	Cigarette and Tobacco Products Tax	Author:	Padilla
Sponsor:	Author	Code Sections:	RTC 30104, 30108, 30181, & Article 4 (commencing with Section 30135)
Related Bills:		Effective Date:	Upon enactment

BILL SUMMARY

This measure would impose an additional excise tax on cigarettes of seventy-five mills per cigarette (\$0.075), or \$1.50 per package of 20 and indirectly increase the tax on other tobacco products. In addition, this measure would impose an equivalent compensating cigarette floor stock tax.¹

ANALYSIS

CURRENT LAW

The current excise tax on cigarettes is 87 cents per package of 20 (43 ½ mills per cigarette). The different components of the cigarette taxes and the disposition of the revenues are as follows:

- 10 cents per pack (5 mills per cigarette) is allocated to the General Fund (Sections 30101 and 30462 of the Revenue and Taxation Code);
- 2 cents per pack (1 mil per cigarette) is allocated to the Breast Cancer Fund (Sections 30101 and 30461.6);
- 25 cents per pack (12 ½ mills per cigarette) is allocated to the Cigarette and Tobacco Products Surtax Fund (Sections 30122 and 30123); and
- 50 cents per pack (25 mills per cigarette) is allocated to the California Children and Families (CCF) Trust Fund (Sections 30131.2 and 30131.3).

For other tobacco products (which are defined in Section 30121 and 30131.1 to include cigars, smoking tobacco, chewing tobacco, snuff, and other products containing at least 50 percent tobacco), Section 30123 (Proposition 99) imposes a tax on the wholesale cost of the tobacco products distributed at a rate which is equivalent to the combined rate of tax imposed on cigarettes. In addition, Section 30131.2 (Proposition 10) imposes an additional tax on tobacco products based on the wholesale cost of the tobacco products distributed at a rate which is equivalent to the 50-cent per pack tax on cigarettes also imposed by Section 30131.2. The tobacco products tax rate is determined annually by the Board of Equalization (BOE) and based on the March 1

¹ A floor stock tax is a one-time tax on all tax-paid (stamped) cigarettes and unaffixed tax stamps in the possession of distributors, wholesalers and/or retailers on the effective date of a cigarette and tobacco products tax increase. The floor stock tax rate is the difference between the old tax rate and the new tax rate.

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wholesale cost of cigarettes. Currently, the surcharge rate for fiscal year 2010 - 2011 is 33.02 percent.

The other tobacco products surtax imposed under Section 30123 (Proposition 99) is deposited into the Cigarette and Tobacco Products Surtax Fund (including any revenues that result from an indirect increase in the other tobacco products tax triggered by a cigarette tax increase), while the surtax imposed under Section 30131.2 (Proposition 10) is deposited into the CCF Trust Fund.

Proposition 10 Backfill. Health and Safety Code Section 130105 (added by Proposition 10) requires the BOE to determine the revenue reductions to any Proposition 99 state health-related education and research programs and the Breast Cancer Fund that are a direct result of the additional taxes imposed by Proposition 10's additional taxes, and annually backfill these amounts from the tax revenues received from Proposition 10.

PROPOSED LAW

Cigarette Tax and Indirect Other Tobacco Products Tax Increases. This measure would add Article 4 (commencing with Section 30135) to Chapter 2 of Part 13 of Division 2 of the Revenue and Taxation Code to impose an additional tax of \$1.50 per package of 20 cigarettes (and, as discussed in Comment 2, page 4, indirectly increases the tax on other tobacco products). The additional cigarette tax would be imposed on or after the first day of the first calendar quarter commencing more than 90 days on and after the effective date of the bill.

Cigarette Tax Rate Adjusted Annually. This bill would require that the additional cigarette tax imposed be adjusted annually and indexed to the California Consumer Price Index (CCPI), as determined by the Department of Industrial Relations. On or before March 1 of each year, the BOE would be required to calculate the percentage increase in the CCPI of December of the prior calendar year over the December of the calendar year immediately preceding the prior calendar year. If there was an increase in the CCPI, the BOE would adjust the cigarette tax rate imposed by this bill with the rate taking effect in the following state fiscal year.

Floor Stock Tax. This measure would also impose upon every dealer and wholesaler a compensating floor stock tax for each cigarette in his or her possession or control at 12:01 a.m. on the first day of the first calendar quarter commencing more than 90 days after the effective date of the bill. In addition, this measure would impose upon every licensed distributor a cigarette indicia adjustment tax on affixed and unaffixed cigarette tax stamp inventory, at 12:01 a.m. on the first day of the first calendar quarter commencing more than 90 days after the effective date of the bill. The floor stock tax return and tax would be due to the BOE on or before the first day of the first calendar quarter commencing 180 days after the effective date of the bill.

Backfill Provisions. This measure would require the BOE to determine, within one year of passage and then annually thereafter, the effect that the additional tax imposed on cigarettes and the resulting increase in the tax on tobacco products required by subdivision (b) of Section 30123 (Prop. 99) has on the consumption of cigarettes and other tobacco products in this state. To the extent that a decrease in consumption is determined by the BOE to be the direct result of the additional cigarette and other tobacco products tax, the BOE shall determine the fiscal effect the decrease in consumption has on the CCF Trust Fund (Prop. 10), the Hospital Services Account, the

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Physician Services Account, the Public Resources Account, the Unallocated Account of the Cigarette and Tobacco Products Surtax Fund (Prop. 99), and the Breast Cancer Fund created by Section 30461.6.

Funds would be transferred from the Tobacco Tax and Health Protection Fund to the California Children and Families Trust Fund (Prop. 10), the Hospital Services Account, the Physician Services Account, the Public Resources Account, the Unallocated Account of the Cigarette and Tobacco Products Surtax Fund (Prop. 99), and the Breast Cancer Fund as necessary to offset the revenue decrease directly resulting from the imposition of the additional cigarette and indirect tobacco products tax.

Fiscal Provisions. Except for payments of refunds and reimbursement of BOE expenses incurred in the administration and collection of the tax imposed by this measure, and except for funds needed to satisfy the backfill provisions, all revenues would be deposited in the Tobacco Tax and Health Protection Fund, which this measure creates in the State Treasury. Money in the Tobacco Tax and Health Protection Fund would be transferred as follows: fifteen percent (15%) would be transferred to the Tobacco Control and Lung Cancer Research Account, which this measure creates in the Tobacco Tax and Health Protection Fund; and eighty-five percent (85%) to the Tobacco Tax General Fund Account, which this measure creates in the General Fund. Upon appropriation by the Legislature, the moneys in the Tobacco Control and Lung Cancer Research Account would be allocated for each fiscal year to fund the following:

- 45% to the State Department of Public Health Tobacco Control Program for carrying out tobacco prevention and control programs.
- 10% to the State Department of Education to be used solely to prevent or reduce the use of tobacco products.
- 10% to the University of California to supplement the Cigarette and Tobacco Products Surtax Medical Research Program.
- 20% to the University of California for the establishment and administration of a Lung Cancer Early Detection and Treatment Research Program.
- 15% to support law enforcement efforts to reduce cigarette and tobacco tax evasion, reduce illegal sales of tobacco products to minors, and to enforce legal settlement provisions and conduct law enforcement training. Of this 15%, 40% would be directed to the BOE to be used to enforce laws that regulate the distribution and retail sale of cigarettes and other tobacco products, such as laws that prohibit untaxed cigarette and tobacco product smuggling and counterfeiting and sales of cigarettes and other tobacco products without a proper license.

The bill would become effective immediately, but the additional excise tax would be operative on or after the first day of the first calendar quarter commencing more than 90 days on and after the effective date of the bill.

BACKGROUND

Proposition 99, approved by voters in November 1988 and effective January 1, 1989, imposed a surtax of 25 cents per package of 20 cigarettes, and also created an equivalent tax on other tobacco products. Proceeds from the taxes provide funding for health education, disease research, hospital care, fire prevention, and environmental conservation.

Assembly Bill 478 (Ch. 660, 1993) and Assembly Bill 2055 (Ch. 661, 1993), effective January 1, 1994, added an excise tax of 2 cents per package of 20 cigarettes for breast cancer research and early detection services.

Proposition 10, approved by voters in November 1998 and effective January 1, 1999, imposed an additional surtax of 50 cents per package of 20 cigarettes. Additionally, the measure imposed an additional excise tax on the distribution of other tobacco products equivalent to the additional cigarette tax and imposed an equivalent compensating floor stock tax. The revenues from the additional tax are deposited into the CCF Trust Fund and are used to fund early childhood development programs, and to offset any revenue losses to certain Proposition 99 programs as a result of the additional tax imposed by Proposition 10.

COMMENTS

1. **Sponsor and Purpose.** This measure is sponsored by the author and is intended to provide funding in order to advance California's tobacco prevention and cancer research efforts.
2. **Indirect other tobacco products rate increase.** This measure does not contain a direct tax increase on other tobacco products, however, the \$1.50 cigarette tax increase would indirectly increase the other tobacco products tax rate as a result of Proposition 99. Section 30123(b) (Proposition 99) generally provides that the other tobacco products tax rate, which is required to be determined annually by the BOE, *must be equivalent to the combined rate of all taxes imposed on cigarettes*. As such, a tax increase on other tobacco products is automatically triggered whenever the tax is increased on cigarettes.

The proceeds from the resulting other tobacco products tax increase would not be deposited into the Tobacco Tax and Health Protection Fund, which this bill would create. The proceeds would be deposited into the Cigarette and Tobacco Products Surtax Fund (Proposition 99) to fund health education, disease research, hospital care, fire prevention, and environmental conservation.

3. **Effective date of the indirect increase on other tobacco products.** Existing law requires the BOE to annually determine the other tobacco products tax rate. As discussed in Comment 2, the \$1.50 cigarette tax increase would indirectly increase the other tobacco products tax rate as a result of Proposition 99. Existing law does not, however, specify when the BOE is required to determine the other tobacco products tax rate, only that it is based on the wholesale cost of tobacco products as of March 1 and must be determined annually for the state's next fiscal year. As such, the rate must be determined no earlier than March 1, but no later than June 30, each year to be effective for the next fiscal year.

4. **This bill could result in an annual adjustment of the cigarette tax.** On or before March 1 of each year, the BOE would be required to calculate the percentage increase in the CCPI of December of the prior calendar year over the December of the calendar year immediately preceding the prior calendar year. If there was an increase in the CCPI, the BOE would adjust the cigarette tax rate imposed by this bill by the percentage increase, with the rate taking effect in the following fiscal year.

The tobacco products rate calculation would include any adjustment in the cigarette tax proposed by this measure.

The annual adjustment language proposed by this measure, however, requires further clarification so that it may be administered as intended by the author. These items include:

- **CCPI Date.** The BOE is required to calculate the percentage increase in the CCPI on or before March 1 of each year; however, the CCPI is typically not available until mid-February, which would not give BOE staff sufficient time to properly calculate any percentage of increase. It would also be problematic if the BOE were to receive the CCPI after the March 1 date. Similar to the annual calculation of the other tobacco products tax rate, the cigarette tax adjustment should be silent with respect to when the BOE is required to make the calculation and instead add general language to require the BOE to make the calculation annually. As such, the reference to the due date of on or before March 1 should be removed from the adjustment language.
- **Annual Tax Base.** The adjustment language provides that “*Each fiscal year, the tax imposed by Section 30135.3 on cigarettes shall be reset by the State Board of Equalization to reflect the California Consumer Price Index percentage increase, if any.*” In other words, each year the tax rate would reset back the rate imposed pursuant to Section 30135.3 (\$1.50 per pack of 20 cigarettes) and would increase only by the percentage increase of the prior year. As such, the rate would not cumulate with each adjustment. For example, let’s assume that the percentage increase from December 2010 to December 2011 calculates to an increase of four cent (\$0.04) per pack of 20 cigarettes. For the subsequent fiscal year, assume that the percentage increase from December 2011 to December 2012 calculates to a five cent (\$0.05) per pack increase. As the language is currently written, the five cent increase would be added to the base tax of \$1.50 per pack, and not to the \$1.54 rate calculated the prior fiscal year. However, if the intent of the annual adjustment is that the rate set each fiscal year is the base rate to which the increase will be added to the following fiscal year, the following language is suggested:

30135.5. To offset the effects of inflation and further reduce smoking prevalence, ~~on or before March 1 of each year, the State Board of Equalization the board shall adjust annually the tax rate imposed upon the distribution of cigarettes pursuant to this article. The tax rate specified in Section 30135.3 on cigarettes is the rate for the fiscal year ending June 30, 2012. Beginning with the state’s next fiscal year, and each fiscal year thereafter, the board shall adjust the rate annually to reflect~~ calculate the percentage increase in the California Consumer Price Index of December of the prior calendar year over December of the calendar year immediately preceding the prior calendar year. ~~Each fiscal year, the tax imposed by Section 30135.3 on cigarettes shall be reset by the~~

~~State Board of Equalization to reflect the California Consumer Price Index percentage increase, if any. The adjusted reset tax rate shall be effective during the state's next fiscal year. For purposes of this section, the term "California Consumer Price Index" means the Consumer Price Index as determined by the Department of Industrial Relations or by a successor agency.~~

5. **Administrative start-up cost funding for the BOE.** The additional excise tax on cigarettes would be imposed beginning on and after the first day of the first calendar quarter commencing more than 90 days after the effective date of this bill. If this bill were to be successfully signed into law, it is assumed it would be signed after April 1, 2011. Accordingly, implementation of the proposed cigarette tax increase would begin during the 2011-12 fiscal year for a January 1, 2012, or April 1, 2012, operative date. Since the BOE's administrative costs to implement this measure are not already identified in the BOE's 2011-12 budget, an appropriation is required to adequately fund the BOE's implementation workload to administer a floor stock tax, notify cigarette distributors, wholesalers and retailers of the additional tax, revise computer programs, reporting forms, and hire appropriate staff.

Typically, the BOE would seek payment from the Tobacco Tax and Health Protection Fund for administrative start-up costs through the budget change proposal (BCP) process. However, the Fund would not have a balance to reimburse the BOE's administrative start-up costs prior to the collection of the tax. To address this funding issue, the bill should be amended to add language authorizing a loan from the General Fund, or other eligible fund, to the Tobacco Tax and Health Protection Fund with repayment from taxes collected and deposited.

The constitutional and statutory provisions prohibit the BOE from using special fund appropriations to support the administration of the proposed cigarette tax increase. Without an appropriation for administrative start-up costs, the BOE would have to divert General Fund dollars to implement the proposed tax, which would have a negative impact on the revenues of State and local government.

6. **Floor stock tax provisions.** Proposed Section 30135.4 contains language to impose a floor stock tax on the cigarette inventory of every dealer, wholesaler, and distributor. The bill does not contain floor stock language for the annual adjustment of the cigarette tax. This is consistent with the other tobacco products tax, which is also adjusted annually.

A floor stock tax is a one-time tax on all tax-paid (fixed stamp) cigarettes and unaffixed tax stamps in the possession of distributors, wholesalers and/or retailers on the effective date of a cigarette tax increase. The floor stock tax rate is the difference between the old tax rate and the new tax rate. Generally, a floor stock tax is imposed to equalize the excise tax paid by cigarette dealers, wholesalers, or distributors on their inventory and those cigarettes purchased after the effective date of a tax increase.

Having a large cigarette inventory before a tax rate increase takes effect can result in a windfall profit to a cigarette seller. The selling price of cigarettes purchased before the increase, but sold after, can be raised and attributed to the rate increase.

These additional funds would represent a windfall profit rather than excise taxes paid to the state. A floor stock tax mitigates this windfall profit. It should be noted that

this measure contains a floor stock tax on cigarettes only, and not other tobacco products.

While the BOE would incur additional costs associated with administering the floor stock tax, these costs would be offset by the proceeds from the tax.

BOE staff suggests a technical amendment to the floor stock tax provisions to clarify that possession includes having title to cigarettes and/or cigarette tax stamps. Such clarification would address any uncertainty with respect to what must be reported when a distributor, wholesaler or retailer does not have physical possession of the merchandise at 12:01 a.m. on the operative date of the tax increase. For example, a distributor, wholesaler, or retailer would not have physical possession of cigarettes and/or tax stamps that are in transit, but such products would be subject to the floor stock tax to the person that holds title to those products.

7. **Cigarette and tobacco products tax evasion.** Tax evasion is one of the major areas that can reduce state revenues generated from cigarettes and other tobacco products taxes. BOE staff recently estimated that cigarette tax evasion in California was running at a rate of approximately \$182 million, along with \$94 million in tax on other tobacco products.²

During the mid-1990's, the BOE's cigarette tax evasion estimates changed little since there was little change to cigarette prices and excise taxes during that time. However, two major events that occurred since November 1998 dramatically increased California excise taxes as well as cigarette prices (excluding taxes): Proposition 10 and the Tobacco Master Settlement Agreement between states and tobacco manufacturers (tobacco settlement). Together, these two developments, when coupled with typical wholesaler and retailer distribution margins, coincided with an increase in the average prices of cigarettes to California consumers by about 50 percent in relation to early November 1998 prices. It is estimated that the impacts of Proposition 10 and the tobacco settlement more than doubled the dollar amount of cigarette tax evasion in California.

Since the 1998 experience, many new measures have been implemented to reduce cigarette and other tobacco products tax evasion. These include the Cigarette and Tobacco Products Licensing Act, an encrypted cigarette tax stamp, and various Internet restrictions (such as the delivery seller requirements imposed by the Jenkins Act).

This measure would increase the cigarette tax substantially, which would result in an increase in the retail price, to the extent that the tax increase is passed along to consumers. Based on previous experience related to Proposition 10 and the tobacco settlement, along with research of experiences in other states, BOE staff believes the proposed cigarette tax increase and resulting increase in the other tobacco products tax could result in both a decrease in actual consumption and an increase in cigarette and other tobacco products tax evasion. The exact magnitude of these responses is uncertain since the proposed excise tax increases are significantly greater than previously experienced.

² <http://www.boe.ca.gov/pdf/cig-evasion-07.pdf>

8. **Increase in state and local sales and use tax revenues.** Under current Sales and Use Tax Law, the total amount of the retail sale is subject to sales or use tax unless specifically exempted or excluded by law. Because the excise tax on cigarettes and other tobacco products is not specifically exempted or excluded, the excise tax is included in the total amount of the sale and subject to sales or use tax.

This measure would increase the excise tax on cigarettes and result in an other tobacco products tax rate increase, which may be passed on to the ultimate consumer through an increase in the retail-selling price of cigarettes and other tobacco products. Any increase in the amount of the retail-selling price of cigarettes as a result of this measure would be included in the amount on which sales or use tax is computed.

9. **Distributor discount.** Under existing law, RTC Section 30166 provides that stamps and meter impression settings shall be sold at their denominated values less 0.85 percent to licensed distributors. The discount is intended to help defray the cost (equipment/labor cost) to the distributor for affixing the stamps.

The BOE is required to submit a report to the Legislature that evaluates the average actual costs associated with applying stamps or meter impressions to cigarette packages pursuant to RTC Section 30166.5. This report is required to be updated every two years with the last report submitted in July 2010, which determined the average actual cost to distributors for applying cigarette tax stamps is \$5.487 per case (600 packs per case).

Currently, distributors receive a case discount of \$4.437 [(600 stamps x \$0.87 tax per package of cigarettes) x 0.85 percent discount = \$4.437 discount]. By increasing the excise tax on a package of 20 cigarettes to \$2.37, this measure would increase the distributor's per case discount to \$12.087 [(600 stamps x \$2.37 tax per package of cigarettes) x 0.85 percent discount = \$12.087 discount], which is \$6.60 more per case than the determined average actual cost distributors to apply cigarette tax stamps.

10. **Backfill provisions.** This bill would require the BOE to determine the effect that the additional cigarette and tobacco products taxes has had on the consumption of cigarettes and other tobacco products in this state. To the extent that a decrease in consumption is determined to be a direct result of the additional cigarette or tobacco products tax, the BOE would be required to determine the fiscal effect the decrease in consumption has on the CCF Trust Fund (Proposition 10), specified accounts within the Cigarette and Tobacco Products Surtax Fund (Proposition 99), and the Breast Cancer Fund. Funds would be transferred from the Tobacco Tax and Health Protection Fund and deposited into the CCF Trust Fund, the specified accounts within the Cigarette and Tobacco Products Surtax Fund, and Breast Cancer Fund, as necessary to offset the revenue decrease directly resulting from the additional cigarette or tobacco products tax.

This measure would not backfill the General Fund or the Health Education Account or the Research Account within the Cigarette and Tobacco Products Surtax Fund.

- 11. Other efforts to increase the cigarette tax.** An initiative to impose an additional excise tax on cigarettes of fifty mills per cigarette (\$0.050), or \$1.00 per package of 20, and indirectly increase the tax on other tobacco products, has qualified for the February 2012 Presidential Primary election ballot. This initiative may also make an earlier appearance on a ballot if a special election is called before the February 2012 election.

COST ESTIMATE

The BOE would incur non-absorbable costs related to the administration and collection of the additional cigarette and tobacco products tax proposed by this measure. These costs would be related to notifying taxpayers, developing returns, programming computers, developing and carrying out compliance and audit efforts to ensure proper reporting, and administering a floor stock tax.

The proposed tax increase would require enhanced efforts to ensure that the floor stock tax is properly reported and collected, greater compliance efforts for additional billings and delinquencies, and increased investigative staff presence due to increased tax evasion.

Supplementary Funding. In addition to reimbursement of the BOE's expenses incurred in the administration and collection of the additional cigarette tax, 15 percent of the moneys deposited into the Tobacco Control and Lung Cancer Research Account would be appropriated by the Legislature to support law enforcement efforts related to cigarette and tobacco products tax evasion, illegal sales to minors, enforce legal settlement provisions and law enforcement training and assistance. Of that 15 percent portion, the BOE would be allocated 40 percent to be used to enforce laws that regulate the distribution and retail sale of cigarettes and other tobacco products, such as laws that prohibit untaxed cigarette and tobacco products smuggling and counterfeiting and sales of cigarette and tobacco products without a proper license.

REVENUE ESTIMATE

This measure would increase the excise tax rate on cigarettes by \$0.075 per cigarette, or \$1.50 per package of 20. It also imposes an equivalent compensating cigarette floor stock tax.

Timing of enactment. There will be partial year revenue impacts for this bill in fiscal year 2011-12. Specific revenues for the 2011-12 fiscal year depend on when the bill is enacted, which is the first calendar quarter more than 90 days after the bill is signed by the Governor and chaptered. The last day the Governor has to sign or veto bills passed by the Legislature is October 9, 2011. While the Governor may sign the bill on or before September 28, (which would imply a January 1 implementation date) we will assume the latest possible signing date. This implies an April 1, 2012 implementation date, which means that revenue impacts in fiscal year 2011-12 will be about a quarter of what they would have been under a complete fiscal year.

BACKGROUND, METHODOLOGY, AND ASSUMPTIONS

Cigarette Tax. Tax-paid cigarette distributions were about 972 million packs in fiscal year 2009-10. So far in fiscal year 2010-11 the underlying trend for tax-paid distributions is estimated to be about a 2 percent decline. Since 1980 tax paid distributions have averaged decreases of about 3 percent per year, which are larger

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losses. We believe that annual declines of about 3 percent are reasonable estimates of the underlying trend for future years. However, state and federal developments during fiscal year 2010-11 likely have mitigated the decline projected by the long-term trend for this particular year. The federal Prevent All Cigarette Trafficking Act (PACT Act) became effective in July 2010. One effect of this act is that it is much more difficult to purchase cigarettes from out-of-state sources without paying California excise taxes. Furthermore, the BOE began issuing a new cigarette stamp in January 2011. The new stamp has enhanced features which should help to improve excise tax compliance. We believe both of these measures caused more cigarettes to be sold through legal channels in fiscal year 2010-11. However, it seems likely that continued declines of about 3 percent per year will take place after this fiscal year is completed, as the main cause for the trend is declining proportions of the population who are smokers. This trend shows no clear signs of abating. We believe 3 percent annual declines for fiscal year 2012-13 and future years are likely without any federal or state law changes.

Based on previous tax increases, many academic studies, and research of experiences in other states, we believe an increase in the tax rate as large as the one proposed by this bill is likely to cause both a decrease in actual consumption and an increase in tax evasion. Although the exact magnitude of the split between evasion and consumption is uncertain, we estimate that the bill would cause a decrease of 13 percent in tax paid distributions. This estimate uses a price elasticity of demand of -0.60 calculated by the arc price elasticity formula, applied to an average estimated November 1, 2011 price of approximately \$5.64 per pack.³

This measure includes an annual adjustment of the \$1.50 per pack excise tax rate based on the CCPI. Assuming a cumulative effect, the CCPI adjustment could potentially add to the tax each year, cumulating the additions of prior years.

Over the past ten years the CCPI has increased an average of about 2.5 percent per year. This implies a typical increase in the tax rate of \$0.04 per pack, which would raise the rate from \$1.50 per pack to \$1.54 per pack in fiscal year 2012-13. With projected tax-paid distributions estimated to be 777 million packs, a typical consumer price index adjustment implies a revenue gain of about \$27 million in additional cigarette tax revenues, taking into account likely consumer responses. As a result of the assumed CCPI adjustment, revenues related to this measure would decline less than one percent per year on average rather than three percent per year, the expected long term decline in tax-paid cigarette distributions.

This bill also includes a corresponding floor stock tax, imposed on inventories on April 1, 2012, our projected implementation date. We assume a three weeks supply of cigarettes would be subject to the floor stock tax, based on a combination of expected sales rates before and after the tax takes effect. Since taxpayers have 180 days after April 1 to remit the tax, we assume that all revenues related to floor stock taxes are received in fiscal year 2012-13.

Tobacco Products Tax. Pursuant to Proposition 99, this measure would result in an additional tax on tobacco products at a rate equivalent to the new \$1.50 per pack that this measure would impose on cigarettes. The BOE sets the tobacco tax rate prior to the start of each fiscal year using wholesale cost data available as of March 1. In recent

³ The general price elasticity of demand formula is: $e_p = (Q_1 - Q_2) / ((Q_1 + Q_2) / 2) / (P_1 - P_2) / ((P_1 + P_2) / 2)$, where P = price and Q = sales.

years the BOE has set the rate in April or May for the upcoming fiscal year. The first year the \$1.50 tax increase would be included in the tobacco tax rate is fiscal year 2012-13.

The tobacco products tax is based on the wholesale costs of these products at a tax rate that is equivalent to the rate of tax imposed on cigarettes. The rate is determined by dividing the tax rate per cigarette by the average wholesale cost per cigarette. In recent years wholesale costs of cigarettes have been rising, which results in rate declines since the total California excise tax on cigarettes has been constant, not changing since 1999. The rate for fiscal year 2010-11 was set by the BOE at 33.02 percent. Without any tax rate changes, we would expect the tobacco products tax rate to decline to 29.52 percent in fiscal year 2012-13 because we believe that wholesale costs of cigarettes are likely to rise at rates similar to those of recent history. We estimate that the tobacco products tax rate in fiscal year 2012-13 would be 61.84 percent with the additional \$1.50 per pack tax.

The wholesale costs (or wholesale sales) of tobacco products were about \$193 million in fiscal year 2009-10. Wholesale sales of tobacco products have increased an average of about 8.5 percent per year over the past three years. We will assume that wholesale costs grow 8.5 percent per year without the proposed tax increase.

Based on previous tax increases, an increase in the tax rate as large as the one proposed by the SB 330 is likely to cause both a decrease in actual consumption and an increase in tax evasion of tobacco products. We estimate the percentage declines in sales of tobacco products would be similar to the percentage decline in cigarette sales.

As mentioned earlier, this measure includes an inflation adjustment to the tax rate on cigarettes based on changes in the CCPI. The CCPI adjustments to the cigarette tax rate indirectly increase the Proposition 99 tobacco tax rate. We estimate that a \$0.04 increase in the tax rate per pack equivalent (a typical CCPI adjustment) would imply a \$1.4 million increase in Proposition 99 tobacco tax revenues, taking into account likely consumer responses.

Sales and Use Tax Impacts. We expect that all of the cigarette and tobacco products tax increases are passed on to consumers. For both cigarettes and tobacco products we added sales taxes on the excise tax increases and subtracted sales taxes resulting from projected declines in sales to determine net sales tax gains.

REVENUE SUMMARY

The revenue impacts of this bill are shown in the following table. Under our assumption of when the bill is enacted, the first complete year that all the provisions of the bill are in effect will be fiscal year 2012-13. For fiscal year 2012-13 the funds created by this measure will receive \$1,165.8 million from cigarette sales at the new tax rate. However, the other cigarette excise funds (including the existing general fund) will lose a combined total of \$102.4 million because fewer packs would be sold. Of this total, all but the General Fund losses (\$11.8 million) and the 25 percent of Proposition 99 accounts will be backfilled. Therefore, the funding anticipated by this bill would be reduced by \$83.2 million to provide monies for backfilling, with net revenues after backfilling totaling \$1,082.6 million.

The impacts on tobacco products tax revenues and sales tax revenues are also shown in the bottom part of the table. Proposition 99 tobacco products revenues increase by \$64.1 million, while Proposition 10 tobacco revenues decrease by \$3.3 million because

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of reduced sales of tobacco products, resulting in a net increase of \$60.7 million for all tobacco products revenues. State and local sales and use tax revenues increase by a combined \$39.8 million. Cigarette and related taxable sales revenues would be expected to decline slightly in fiscal year 2013-14 and future years because we assume that tax paid distributions continue to decrease.

Revenue Impacts Summary		
	Fiscal Year	
	2011-12	2012-13
	(\$ Millions)	
Cigarette Excise Tax Revenue Impacts by Fund		
Impacts on Existing Funds:		
General Fund (Current Law Portion)	-\$3.0	-\$11.8
Breast Cancer	-\$0.6	-\$2.4
Proposition 99	-\$7.6	-\$29.4
Proposition 10	-\$15.2	-\$58.8
Tobacco Tax and Health Protection Fund	\$300.5	\$1,165.8
Floor Stocks Tax (Excluded from totals)	\$0.0	\$74.6
Net Total Cigarette Excise Tax Revenues (Certain Funds Backfilled)	\$279.0	\$1,082.6
Tobacco Tax Revenue Increase	\$0.0	\$60.7
Total Net Excise Tax Increase (Cigarettes Plus Tobacco Taxes)	\$279.0	\$1,143.3
State Sales and Use Tax	\$6.8	\$25.8
General Fund (5.00%)	\$6.5	\$24.5
Fiscal Recovery Fund (0.25%)	\$0.3	\$1.2
Local Sales & Use Tax (2.0%)	\$2.6	\$9.8
Transit Tax (at 0.86%)	\$1.1	\$4.2
Total (Excluding Floor Stock Revenues)	\$289.5	\$1,183.1
Associated Revenue Impacts on Other Tobacco Tax Revenues		
<i>(Change from revenues under current law, millions of dollars)</i>		
Proposition 99		\$64.1
Proposition 10		-\$3.3
Total Impact		\$60.7

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This staff analysis is provided to address various administrative, cost, revenue and policy issues; it is not to be construed to reflect or suggest the BOE's formal position.